



Analysis of the 2005-06 Budget Bill

*Legislative Analyst's Office
February 2005*

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Retiree Benefits Pose Long-Term Challenge

We recommend the Legislature require county offices of education and school districts to take steps addressing districts' long-term retiree health benefit liabilities.

In 2004, the Governmental Accounting Standards Board (GASB) issued a new policy describing how state and local governments (including schools and community colleges) must account for nonpension retirement benefits such as health insurance. For K-12 and community college districts, the GASB policy requires each district to include its long-term liabilities for post-retirement benefits in its annual financial statement. One component of this new liability statement is an identification of the amount that, if paid on an ongoing basis, would provide sufficient funds to pay for benefits as they come due.

In other words, GASB requires districts to account for health and other retirement benefits similarly to the way they account for pension costs. For retirement, an amount is contributed to a fund each year for each employee. Over the years, these payments are set at a level sufficient to pay for the full cost of retirement benefits for the average employee. In effect, the retirement benefits are "prefunded"—that is, their costs are provided for over the working life of the employee. (Also, contributions are set aside in a special "trust" fund so they cannot be used for any other purpose.) The new GASB policy encourages districts to pay for retiree health benefits in the same way, thereby avoiding the accumulation of large unfunded liabilities for future benefits. The GASB policy, however, does not require such annual payments or public agencies to act on any past liabilities—it only requires the reporting of such liabilities. We are not aware of any school district that has prefunded its retiree health benefits. Instead, these costs are paid out of districts' operating budgets as they are incurred by retirees.

Some District Liabilities Are Huge

The liabilities some districts face are very large—so large they potentially threaten the district's ability to operate in the future. For instance, Los Angeles Unified School District (LAUSD) estimates its current "actuarial liability" for retiree health benefits at \$5 billion. This figure is the amount the district would need to place in an interest-bearing account in 2005 to pay for these benefits over time. To provide a sense of the size of this liability, the \$5 billion estimate for LAUSD is the equivalent of about 80 percent of the district's general purpose annual operating budget. Other districts face a similar problem. Fresno Unified estimates its liability at \$1.1 billion—almost twice its annual budget. The cost for both districts is very high because each provides lifetime health benefits to retirees.

While these costs are not yet at a stage that will seriously erode the district's ability to function, both districts are experiencing rapidly increasing annual costs for these benefits.

In Los Angeles, for instance, the district budget includes about \$170 million for retiree health benefits in 2004-05. The district estimates the annual cost of these benefits will grow to about \$265 million by 2010 and \$360 million by 2015. The district would have to add \$500 million to the budget—about 8 percent of its overall budget—starting next year and continuing for the next 30 years to pay off its unfunded liabilities and prefund future retiree health benefits.

Weak District Incentives to Face Liabilities. Districts do not have much incentive to address this problem. In the short run, the need to set aside funds for this obligation would only complicate budgeting as it would reduce funding available for other local priorities. Furthermore, any financial crisis resulting from these liabilities may be years or decades away. For these reasons—and especially given the number of financial pressures districts currently face—districts will be reluctant to take the needed steps to address this problem. There is one way, however, that the new GASB policy may prod districts to address these liabilities. Large liabilities could affect a district's bond rating and increase the costs of borrowing. Pressure from credit agencies, therefore, represents one of the few short-term incentives for addressing retiree costs that will result from the new policy.

Liabilities Could Be Even Larger. Districts may also have an incentive to understate their actual liabilities. The GASB policy left many details of the actuarial calculation of liabilities to local agencies. While this makes sense given the range of state and local agencies affected by this policy, it also allows local agencies the ability to make assumptions that minimize their apparent liability. Small changes in the underlying assumptions used in these studies have a major impact on the results. For instance, the LAUSD's actuarial study determined a \$5 billion actuarial liability using "best estimate" assumptions. This figure increased to \$7 billion if all current and retired employees were included in the calculation instead of retirees plus those employees whose health retirement benefits are vested. Moreover, the figure grew to \$11 billion if the long-term interest rate the district would earn on its annual contributions was reduced from 6 percent to 4 percent. Thus, we think it is in the state's interest to ensure districts use reasonable assumptions in their actuarial studies.

Require District Plans for Addressing Liabilities

The size of retiree health benefit liabilities is so large that unless steps are soon taken to address the issue, it seems likely that districts will eventually seek financial assistance from the state. As a first step, we think the Legislature needs to establish a process for ensuring that districts identify and address the liabilities created by post-retirement benefits. Currently, there is no state or local process for collecting information on the financial liabilities districts presently face or whether districts have a plan for addressing these liabilities. In addition, the long-term liabilities of retiree benefits are not part of the AB 1200 district fiscal review process. As a result, COEs are not always aware of which districts provide retiree benefits or the magnitude of the costs for those benefits.

About 150 districts present the most serious problem. Of these, 70 districts provide lifetime health benefits to retirees and represent the districts that probably have the most serious fiscal problem. Another 80 districts provide health benefits from the time an employee retires to a specific age—most commonly age 70. These districts also may face significant fiscal challenges.